

FEDERAL RESERVE SYSTEM

[Docket No. R-1032]

Settlement-day Finality for Automated Clearing House Credit Transactions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board has decided to make the settlement for ACH credit transactions processed by the Federal Reserve final when posted, which is currently 8:30 a.m. eastern time on the day of settlement. The Board considered a number of risk control measures and has decided to require prefunding for any ACH credit originations that settle through the Federal Reserve account of a depository institution that is being monitored in real time. The Board believes that settlement-day finality for ACH credit transactions will reduce risk to receiving depository financial institutions (RDFIs) and receivers and that the prefunding requirement will permit the Reserve Banks to manage their settlement risk as effectively as they do for other services with similar finality characteristics. The changes will be implemented by the Reserve Banks in early 2001 to permit time for necessary software modifications. A specific implementation date will be announced three months in advance of the effective date.

FOR FURTHER INFORMATION CONTACT: Jack K. Walton II, Manager, Retail Payments (202/452-2660); Myriam Y. Payne, Manager, Payment Systems Risk (202/452-3219); or Jeffrey S. H. Yeganeh, Senior Financial Services Analyst (202/728-5801), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only, contact Diane Jenkins, Telecommunications Device for the Deaf (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets NW, Washington D.C. 20551.

SUPPLEMENTARY INFORMATION:

Background

In December 1998, in response to renewed calls from the banking industry to reduce the interbank settlement risk by improving the finality of ACH credit transactions, the Board requested comment on the benefits and drawbacks of making settlement for ACH credit transactions processed by the Federal Reserve Banks final when posted, which is currently 8:30 a.m. eastern time on the day of settlement (63 FR 70132, December 18, 1998). The Reserve Bank's uniform ACH operating circular gives the Reserve Banks the right to reverse settlement for credit transactions until 8:30 a.m. eastern time on the business day following the settlement day (Reserve Bank Operating Circular 4, Section 11.2). Specifically, a Reserve Bank can reverse settlement if it does not receive actually and finally collected funds from the originating depository financial institution (ODFI) by 8:30 a.m. eastern time on the business day following the settlement day. The Reserve Bank's current ACH risk control measures include ex post monitoring of daylight overdraft trends, requiring an ODFI at imminent risk of failure to prefund the value of the ACH credit transactions it originates, and reversing ACH credit transactions if an ODFI is unable

to settle for those transactions. Under these risk control measures, the Reserve Banks have never incurred a financial loss due to the failure of an ODFI to settle for its ACH credit transactions.

The Board noted, however, that it did not believe that current risk control measures provided Reserve Banks with adequate protection from settlement risk if settlement were to become final before the Reserve Banks knew whether depository institutions could fund the payments. Moreover, because the ACH is a value-dated mechanism and transactions could be processed two days before settlement, a simple balance check of an institution's settlement account at the time that a transaction is processed would be ineffective in managing risk. While an institution's available account balance may be sufficient to settle for its ACH credit originations at the time they are processed, those funds may be unavailable at the time of settlement.¹

Further, the Board noted that if the Reserve Banks were to provide settlement-day finality for ACH credit transactions, they should adopt risk control measures commensurate with those used in connection with other Federal Reserve services with similar finality characteristics, such as the Fedwire funds transfer service and the enhanced net settlement service. The Board believed that the adoption of commensurate risk controls would be critical to preventing the creation of incentives for monitored institutions to move payments from Fedwire to the ACH to avoid risk management controls. Specifically, the funds transfer and enhanced net settlement services, which provide final and irrevocable settlement at the time a transaction is credited to the depository institution's account, use real-time account balance monitoring to manage settlement risk. Reserve Banks apply real-time monitoring to a depository institution when they believe that additional controls over the institution's account activity are appropriate. For example, Reserve Banks apply real-time monitoring to institutions in weak financial condition or to institutions with chronic overdrafts in excess of what the Reserve Banks determine is prudent.² When a depository institution is monitored in real time, Reserve Banks control their risk exposure by rejecting or delaying certain payment transactions with immediate finality if the institution's account balance would be exceeded.³ Thus, for institutions monitored in real time, a funds transfer or enhanced net settlement entry will not be processed unless the institution's available account balance is sufficient to fund the debit entry. The Board believed that a prefunding requirement for depository institutions being monitored in real time would enable Reserve Banks to manage their settlement risk using risk control measures that are commensurate with those used in services with similar finality characteristics.

¹ An institution's available balance includes its Federal Reserve account balance plus any available intraday credit.

² The majority of depository institutions currently being monitored in real time are being monitored for reasons other than financial condition.

³ Most depository institutions, however, are not monitored in real time. The account activity of an institution that is not monitored in real time is monitored for compliance with the daylight overdraft transaction posting rules on an ex post basis. As a result, Reserve Banks are able to control their credit risk exposure by monitoring the account balances of a selected group of depository institutions in real time, thereby restricting those institutions' access to Federal Reserve intraday credit.

Summary of comments

The Board received twenty-nine comment letters in response to its December 1998 request for comment. The following table shows the number of comments by the category of commenter:

Category of commenter	Number of responses
Banks and bank holding companies	11
Associations representing depository institutions	9
Federal Reserve Banks	5
Corporate credit unions	2
Associations representing corporations	1
Government agencies	1
Total	29

Twenty-seven commenters supported and two commenters opposed settlement-day finality for ACH credit transactions processed by the Reserve Banks. Further, nine commenters specifically supported and three commenters opposed the use of prefunding, as outlined in the December 1998 request for comment, as a risk control measure. Twenty-one commenters cited the reduced risk to RDFIs and receivers as a benefit of settlement-day finality for ACH credit transactions. Additionally, five commenters believed that settlement-day finality would increase confidence in the ACH, facilitate product innovation, be consistent with settlement finality offered by private-sector ACH operators, and be consistent with the National Automated Clearing House Association's (NACHA) rules for consumer entries and marketplace practices for corporate entries.⁴ Eight commenters believed that the overall attractiveness of the ACH would increase and five commenters noted that the creditworthiness of the ACH would improve as a result of prefunding.

Several commenters noted, however, that the risk of credit transactions not settling on the intended settlement day, the potential difficulty of prefunding transactions deposited shortly before the 3:00 a.m. deposit deadline, and the liquidity drain on ODFIs (or their correspondents) that are required to prefund represent potential drawbacks of settlement-day finality with prefunding as a risk control measure. Seven commenters suggested that ODFIs that are required to prefund might have to alter their funding practices, which may put them at a competitive disadvantage in providing origination services. Further, nine commenters believed that if ACH credit transactions were rejected or delayed due to the prefunding requirement, the public's confidence in the ACH would be undermined.

⁴ NACHA Operating Rules Section 4.4.1 requires an RDFI to make funds from credit entries available for cash withdrawal on the settlement day. Further, for credit entries to a consumer's account that are made available to the RDFI by 5:00 p.m. local time on the day before the settlement day, the RDFI must make the funds available for cash withdrawal by opening of business on the settlement day.

Six commenters believed that prefunding for an ODFI that settles its ACH transactions through a correspondent should be based on the ODFI's risk profile and not that of the correspondent. These commenters believed that, because the ODFI is ultimately obligated to settle for the transactions and because a correspondent would not be permitted to revoke the settlement designation for transactions that had already been processed, prefunding should be based on the ODFI's financial condition. These commenters also stated that requiring prefunding based on the correspondent's risk profile would result in the disclosure of information regarding the financial condition of the correspondent. Three commenters, however, believed that prefunding should be based on the risk profile of the correspondent because the correspondent settles for the transactions and that the correspondent should manage its risk by monitoring the creditworthiness of the ODFIs to whom it provides services.

The commenters were asked about alternative risk control measures that the Reserve Banks could use to manage their risk. Six commenters suggested that the Reserve Banks collateralize the ACH credit originations of ODFIs monitored in real time. These commenters believed that, through the use of collateral, the Reserve Banks could grant settlement-day finality with little risk of loss that might result from the failure of an ODFI. Also, one commenter supported the use of the Reserve Banks' enhanced net settlement service and one commenter supported the use of origination caps for ODFIs monitored in real time.

Some commenters indicated that if the Reserve Banks granted settlement-day finality for ACH credit transactions, settlement finality would no longer be a consideration in the choice of ACH operator. Other commenters suggested that settlement-day finality was not a major factor in the choice of ACH operator. Six commenters believed that settlement-day finality would result in an increase in the use of the ACH for various reasons, including reduction in risk, ACH product innovation (such as cross-border ACH services), and a shift of volume from other payment mechanisms, such as check and Fedwire funds transfer. A few commenters believed that settlement-day finality would not have a major influence on ACH volume.

Requiring prefunding to manage the Reserve Banks' settlement risk

After carefully considering the comments received, the Board has decided to make the settlement for ACH credit transactions processed by the Reserve Banks final when posted, which is currently 8:30 a.m. on the settlement day. Further, the Board has decided to require prefunding for any ACH credit originations that settle through a settlement account that is being monitored in real time. The Board believes that this prefunding requirement will permit the Reserve Banks to manage their settlement risk as effectively as they do for other services with similar finality characteristics. Prior to the implementation of settlement-day finality and prefunding, the Reserve Banks will have to modify their software and revise their ACH operating circular. To permit time to make the required changes, settlement-day finality for ACH credit transactions will be implemented in early 2001. A specific implementation date will be announced three months in advance of the effective date.

Under prefunding, if an ODFI's settlement account is being monitored in real time, the Reserve Banks would process the transactions only after the settlement account has been debited. On the settlement day, the Reserve Banks would credit the ODFI's settlement account with final

funds.⁵ If the available balance in the ODFI's settlement account were not sufficient to fund the transactions, the transactions would generally not be processed until the settlement account was funded. Most ODFI settlement accounts are not monitored in real time, however. In these cases, ACH credit originations would not be prefunded and the incoming files would be processed as they are today. If an institution that settles an ODFI's ACH transactions fails unexpectedly, the Reserve Banks would reserve the right to reverse the ACH credit transactions that have not yet settled and would send reversal files to RDFIs for those transactions. Reserve Banks, however, would not reverse transactions that had already settled, as the settlement would have been final.

The Board has decided to use prefunding to manage risk for several reasons. First, the Board believes that the prefunding of ACH credit transactions that settle through accounts that are monitored in real time would establish risk control measures for the Reserve Banks' ACH service that are commensurate with those used in the Fedwire funds transfer and enhanced net settlement services. The adoption of commensurate risk controls should discourage monitored institutions from moving payments from Fedwire to the ACH to avoid risk management controls. Second, the Board identified concerns with the alternate risk control measures suggested by the commenters.

Specifically, commenters suggested the use of collateral, the use of the enhanced net settlement service, and the use of origination caps as risk control measures. The use of collateral as a risk control measure is inconsistent with the Board's payments system risk policy that restricts the use of collateral for intraday extensions of central bank credit to overdrafts resulting from book-entry securities transfers and certain other special situations. As the Board, over time, reviews its payments system risk policy, it will examine the appropriateness of the policy's restrictions on the use of collateral. The Board, however, believes that it would be inappropriate to modify its payments system risk policy solely for the purpose of granting settlement-day finality for ACH credit transactions when other viable options are available. The suggestion that the Reserve Banks use the enhanced net settlement service to settle ACH transactions they process does not take into account other risk controls that private settlement arrangements typically employ to facilitate a smooth settlement process. For example, while Reserve Banks make ACH services available to all institutions regardless of financial condition, private-sector ACH operators typically manage their risk by using membership criteria to exclude financially troubled institutions from participation in their private ACH exchange. The use of membership criteria enables private-sector ACH operators to help ensure that the net settlement for their ACH exchanges takes place without difficulty and in a timely fashion. Finally, the use of origination caps, as a risk control measure, would not protect the Reserve Banks from the risk of financial loss should there be insufficient funds in the account where ACH credit originations are designated to settle.

The Board recognizes a number of drawbacks associated with prefunding as a risk control measure but does not believe that they are of sufficient magnitude to prevent the adoption of settlement-day finality for ACH credit transactions using prefunding to control risk. The Board

⁵ The Reserve Banks will not provide as-of adjustments to compensate institutions for the float generated through the prefunding requirement. The Board expects that ODFIs will modify their operations to minimize the costs associated with prefunding by depositing ACH credit transactions closer to the deposit deadline.

agrees with commenters that if ACH credit transactions are delayed or do not settle on the intended settlement day, then the public's confidence in the ACH could be undermined. While short-term disruptions may occur if settlements are delayed or do not settle on the intended settlement day, the Board believes that, in the long term, market forces should result in fewer delayed settlements as originators more closely monitor the condition of their ODFIs and ODFIs more closely monitor the condition of their correspondents. The Board also recognizes that it may be difficult for an institution being monitored in real time to prefund gross ACH transactions, particularly near the 3:00 a.m. deposit deadline. This situation will likely necessitate changes in operational or funding practices at these institutions as they will have to ensure that they have sufficient funds in their settlement accounts to fund their ACH gross originations.

Finally, the Board has decided that, in cases where an ODFI uses a correspondent to settle for its ACH transactions, the prefunding requirement should be based on whether the correspondent's account is being monitored in real time. While an ODFI is ultimately responsible for settling its ACH transactions, some ODFIs do not have account relationships with the Federal Reserve and designate a correspondent settlement account to settle their ACH transactions. When an ODFI's ACH credit transactions settle through a correspondent, the potential for insufficient funds in the correspondent's account at the time of settlement is a function of the risk profile of the correspondent. Thus, the risk profile of the correspondent is critical in the management of the Reserve Bank's settlement risk. If the correspondent is being monitored in real time, the Reserve Banks would require the correspondent to prefund the ODFI's ACH credit transactions. If the correspondent is not being monitored in real time, the Reserve Banks would not require prefunding for ACH credit transactions that settle through the correspondent.

Competitive impact analysis

In assessing the competitive impact of granting settlement-day finality for ACH credit transactions processed by the Reserve Banks, the Board considers whether there will be a direct and material adverse effect on the ability of other service providers to compete with the Federal Reserve due to differing legal powers or due to the Federal Reserve's dominant market position deriving from such legal differences.⁶

Although the Federal Reserve's ACH service does not derive its dominant market position from legal differences, the fact that the Federal Reserve maintains accounts directly or indirectly for all depository institutions to settle may make it easier for some institutions to use the Federal Reserve's services. The enhanced net settlement service was designed, in part, to offset that potential advantage by making it easier for a private-sector entity to function settlement entries to depository institutions nationwide. As was discussed above, the enhanced net settlement service checks the available account balance of depository institutions that are being monitored in real time and debits the accounts of institutions in a net debit position if sufficient funds are available; otherwise, the settlement is delayed until funding situation is resolved. If the Reserve Banks were to improve the settlement finality for the ACH transactions they process without implementing similar risk controls, competitive questions might be raised. The Board, however, believes that

⁶ The Federal Reserve in the Payments System, FRRS 7-145.2

the expanded use of prefunding provides risk controls commensurate with those of the enhanced settlement service.

While private-sector operators that use the Fedwire-based or enhanced net settlement service will be able to offer settlement-day finality for the ACH credit transactions they process, they typically do not require prefunding from participants with higher risk profiles. As discussed above, private-sector ACH operators manage their settlement risk by limiting their services to those institutions that meet their admission criteria. Nevertheless, private-sector ACH operators could require prefunding from their participants as an additional risk control measure, if they chose to do so. Thus, the Board does not believe that settlement-day finality for ACH credit transactions processed by the Federal Reserve and conditioned on the expanded use of prefunding would adversely affect competition in the provision of interbank ACH services.

By order of the Board of Governors of the Federal Reserve System, November 10, 1999.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,
Secretary of the Board.